

An organization which has been denied exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 by reason of having engaged in a prohibited transaction described in section 503(c)(1) of the Code may not reestablish exemption until the loan which was the prohibited transaction has been repaid or adequately secured.

Advice has been requested whether an organization which has been denied exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 by reason of having engaged in a prohibited transaction described in section 503(c)(1) of the Code may reestablish exemption before the loan which was the prohibited transaction has been repaid or adequately secured.

An organization, exempt from Federal income tax under section 501(c)(3) of the Code and subject to the provisions of section 503 of the Code, loaned a part of its corpus to a substantial contributor without the receipt of adequate security. The loan was evidenced by a promissory note maturing five years from the date of issuance. The organization was denied exemption because the loan was a prohibited transaction described in section 503(c)(1) of the Code. Thereafter, the organization filed a new application for exemption under section 501(c)(3) of the Code with respect to subsequent taxable years. The application contained an affidavit by its president that the organization would not knowingly again engage in a prohibited transaction. The existing loan, however, had not been repaid nor had adequate security been furnished.

Section 501(a) of the Code provides in effect that exemption from Federal income taxes does not extend to an organization engaged in a prohibited transaction. Section 503(d) of the Code provides for the reinstatement of exemption to organizations previously denied exemption because of a prohibited transaction.

Section 1.503(d)-1 of the Income Tax Regulations requires such organization to submit a written declaration by a principal officer that it will not knowingly again engage in a prohibited transaction and to satisfy all other requirements under section 501(c)(3) of the Code. However, these regulations presuppose that, in the case of an organization denied exemption by reason of its having engaged in a prohibited transaction, the grounds for the original denial of exemption shall have been removed before an exemption may be reinstated for future years. Otherwise the organization would continue to be in violation of section 501(a) of the Code.

In this case, the transaction causing the denial of exemption carried into subsequent taxable years. Part of the organization's corpus was still loaned to a substantial contributor without the receipt of adequate security. Thus, the loan continued as a prohibited transaction. Accordingly, until the loan was repaid or

adequate security for the loan received, the organization was not entitled to reestablish exemption under section 501(c)(3) of the Code.